(5)

No. 95-323

Supreme Court, U.S.
FILED
FEB 29 1996
CLERK

In The

Supreme Court of the United States

October Term, 1995

UNITED STATES OF AMERICA,

Petitioner,

vs.

THOMAS R. NOLAND, TRUSTEE FOR DEBTOR FIRST TRUCK LINES, INC.,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

BRIEF FOR RESPONDENT

RAYMOND J. PIKNA, JR.
Counsel of Record
THOMAS R. NOLAND
ROBERT B. BERNER
GREGORY P. GARNER
ALTICK & CORWIN CO., L.P.A.
Attorneys for Respondent
1700 One Dayton Centre
One South Main Street
Dayton, Ohio 45402
(513) 223-1201

7617
Lutz Appellate Services, Inc.
BEST AVAILABLE COPY

QUESTION PRESENTED

The Bankruptcy Code does not define the term "principles of equitable subordination." A pecuniary loss claim is susceptible to equitable subordination if there has been misconduct by the claimant. Enforcement of a nonpecuniary loss tax penalty claim against a bankruptcy estate would serve not to punish the delinquent taxpayer, but rather its entirely innocent creditors. Five circuit courts of appeals considering the application of 11 U.S.C. § 510(c) have concluded that nonpecuniary loss tax penalty claims may be equitably subordinated pursuant to 11 U.S.C. § 510(c) without a finding of governmental misconduct. This case presents the following question:

Whether the bankruptcy court in a chapter 7 case of a liquidated corporate debtor properly exercised its discretion under 11 U.S.C. § 510(c)(1) to equitably subordinate the administrative expense nonpecuniary loss tax penalty claims of the IRS to the actual pecuniary loss claims of entirely innocent claimants, including the actual pecuniary loss claims of general unsecured creditors, when the nonpecuniary loss tax penalty claims arose after the corporate debtor filed its chapter 11 petition but before its case was converted to chapter 7.

TABLE OF CONTENTS

	Page
Question Presented	i
Table of Contents	ii
Table of Citations	iii
Statement of the Case	1
Introduction and Summary of Argument	8
Argument	10
Equitable Subordination of the Postpetition Nonpecuniary Loss Tax Penalty Claims of the IRS Pursuant to 11 U.S.C. § 510(c) Was Proper.	10
A. Since Nonpecuniary Loss Claims Are Fundamentally Different from Pecuniary Loss Claims, They May Be Treated Differently.	12
B. Other Provisions of the Bankruptcy Code Support the Subordination of Punitive Nonpecuniary Loss Tax Penalty Claims.	17
C. Subordination of Punitive Nonpecuniary Loss Tax Penalty Claims Is Consistent with Prior Decisions of This Court.	25
D. The Legislative History Accompanying 11 U.S.C. § 510(c) Supports the Subordination of Punitive Nonpecuniary Loss Tax Penalty Claims.	29

	Page
Conclusion	36

TABLE OF CITATIONS

Cases Cited:

Begier v. Internal Revenue Service, 496 U.S. 53 (1990)	12, 31
Benjamin v. Diamond, 563 F.2d 692 (5th Cir. 1977)	29
Boteler v. Ingels, 308 U.S. 57 (1939)	25, 26
Burden v. United States, 917 F.2d 115 (3d Cir. 1990)	2, 6, 14
In reCassis Bistro, Inc., 188 Bankr. 472 (Bankr. S.D. Fl. 1995)	22
Comstock v. Group of Institutional Investors, 335 U.S. 211 (1948)	4, 5, 28
In re CF&I Fabricators of Utah, Inc., 53 F.3d 1155 (10th Cir. 1995), *cert. granted*, No. 95-325 (December 1, 1995)	15, 16
In re Columbia Ribbon Co., 117 F.2d 999 (3d Cir. 1941)	13, 14
In re First Truck Lines, Inc., 48 F.3d 210 (6th Cir. 1995), *cert. granted*, No. 95-323 (December 1, 1995)	15, 16
In re Stirling Homex Corp., 579 F.2d 206 (2d Cir. 1978), *cert. denied*, 439 U.S. 1074 (1979)	5

Contents

Page

In re Mansfield Tire & Rubber Co., 942 F.2d 1055 (6th Cir. 1991), *cert. denied*, 502 U.S. 1092 (1992) 4, 5

In re Samuel Chapman, Inc., 394 F.2d 340 (2d Cir. 1968), *cert. denied*, 393 U.S. 923 (1968) 26

In re Virtual Network Services Corp., 902 F.2d 1246 (7th Cir. 1990) 2, 6, 14, 15, 16, 34

New Jersey v. Anderson, 203 U.S. 483 (1906) 26

Nicholas v. United States, 384 U.S. 678 (1966) 25, 26

Northern Pipeline Construction Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982) 17

Pepper v. Litton, 308 U.S. 295 (1939) 4, 5, 26, 27, 28

Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215 (1941) 12, 26

Schultz Broadway Inn v. United States, 912 F.2d 230 (8th Cir. 1990) 2, 6, 14, 16, 32

Simonson v. Granquist, 369 U.S. 38 (1962) ... 5, 17, 20, 21, 34

Stebbins v. Crocker Citizens Nat'l Bank, 516 F.2d 784 (9th Cir. 1975) 29

Taylor v. Standard Gas & Electric Co., 306 U.S. 307 (1939) 4, 5, 26, 27, 28

Contents

Page

United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd., 484 U.S. 365 (1988) 19

United States v. Killoren, 119 F.2d 364 (8th Cir. 1941), *cert. denied*, 314 U.S. 640 (1941) 13

United States v. Ron Pair Enterprises, Inc., 489 U.S. 235 (1989) 11, 18

United States Department of Interior v. Elliott, 761 F.2d 168 (4th Cir. 1985) 26

Statutes Cited:

11 U.S.C. § 57(j) (Repealed) 16, 17

11 U.S.C. § 93(j) (Repealed) 5, 16, 17

11 U.S.C. § 103(a) (Repealed) 21

11 U.S.C. § 104a (Repealed) 13

11 U.S.C. § 322 22

11 U.S.C. § 364 ..... 22, 24

11 U.S.C. § 364(c) 8, 24

11 U.S.C. § 364(e) 23

11 U.S.C. § 502 ..... 6, 18

Page

11 U.S.C. § 503(b) 18

11 U.S.C. § 503(b)(1) 26

11 U.S.C. § 503(b)(1)(B) 19, 22

11 U.S.C. § 503(b)(1)(C) 9, 18, 19, 22

11 U.S.C. § 505 6

11 U.S.C. § 507 ..... 6, 12

11 U.S.C. § 507(a) 9

11 U.S.C. § 507(a)(6) 9

11 U.S.C. § 507(a)(7) 9, 20

11 U.S.C. § 507(a)(7)(G) 9, 16, 20, 21

11 U.S.C. § 507(a)(8) 9

11 U.S.C. § 510 ..... 3, 11, 18, 29, 30

11 U.S.C. § 510(c) .....
..... i, 5, 6, 7, 8, 9, 10, 11, 12, 14, 17, 18, 22, 29, 30

11 U.S.C. § 510(c)(1) .....
..... 1, 2, 8, 9, 10, 14, 15, 25, 26, 29, 31, 34, 35, 36

11 U.S.C. § 726 ..... 6, 12

Page

11 U.S.C. § 726(a) 3, 7, 10, 12, 18

11 U.S.C. § 726(a)(1) 21

11 U.S.C. § 726(a)(4) 9, 16, 17, 20, 21

11 U.S.C. § 1101(1) 2

11 U.S.C. § 1107 22

11 U.S.C. § 1108 22

11 U.S.C. § 1122(a) 20

11 U.S.C. § 1129(a)(7) 21

11 U.S.C. § 1141(b) 16

11 U.S.C. § 1222(a)(3) 20

11 U.S.C. § 1322(a)(3) 20

Other Authorities Cited:

A. Herzog and J. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 Vand. L. Rev. 83 (1961) .. 15

Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93d Cong., 1st Sess. Pt. II 115, § 4-406(a)(3)(1973) 29, 30

Contents

	Page
124 Cong. Rec. H11,089 (Sept. 28, 1978)	2, 31, 34
124 Cong. Rec. H11,095 (Sept. 28, 1978)	2, 31, 34
124 Cong. Rec. S17,406 (Oct. 6, 1978)	2, 31, 34
124 Cong. Rec. S17,412 (Oct. 6, 1978)	2, 31, 34
S. Rep. No. 95-989, 95th Cong., 2d Sess. 74 (1978)	33

APPENDIX

Appendix A — Hypothetical Chapter 11 Distribution Analysis	1a
Appendix B — Request for Payment of Internal Revenue Taxes (Proof of Claim #102) with Attached Letter Filed November 22, 1988	7a
Appendix C — Best Interest of Creditors Test Hypothetical [11 U.S.C. § 1129(a)(7)]	14a

Respondent, Thomas R. Noland, Trustee for Debtor First Truck Lines, Inc. (the "Trustee"), respectfully requests that this Court affirm the judgment of the United States Court of Appeals for the Sixth Circuit in this case. The opinion of the court of appeals (Pet. 1a-22a) is reported at 48 F.3d 210.

STATEMENT OF THE CASE

1. First Truck Lines, Inc. ("FTL") filed its chapter 11 petition on April 10, 1986 (Pet. App. 2a). FTL's chapter 11 plan was confirmed by order entered June 2, 1987 (Resp. App. 3a). The nonpecuniary loss tax penalty claims of the Internal Revenue Service ("IRS") at issue are for the tax period ended December 31, 1987 and for the post-confirmation tax quarters ended September 30, 1987, March 31, 1988, and June 30, 1988, respectively (Resp. App. 7a). The case was converted to chapter 7 on August 1, 1988, and Thomas R. Noland was appointed Trustee for FTL (Pet. App. 2a). Petitioner and the Trustee applied to the bankruptcy court for a determination of the priority, if any, to be accorded to the nonpecuniary loss tax penalty claims of the IRS (Resp. App. 11a, 12a).

2. After finding that the nonpecuniary loss tax penalty claims of the IRS were administrative expenses (Pet. App. 40a, 53a), the bankruptcy court considered whether those claims should be subordinated pursuant to 11 U.S.C. § 510(c)(1), which provides:

> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may —
>
> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an

> allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest . . .

(Pet. App. 42a). Because the Bankruptcy Code does not define the term "equitable subordination," the bankruptcy court then examined the legislative history, which states that the term is to follow existing case law and that its meaning is to be developed by the courts:

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if the holder of such claim is guilty of inequitable conduct, *or the claim itself is of a status susceptible to subordination, such as a penalty* or a claim for damages arising from the purchase or sale of a security of the debtor.

124 Cong. Rec. H11,089, H11,095 (Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. S17,406, S17,412 (Oct. 6. 1978) (statement of Sen. DeConcini) (Pet. App. 43a, emphasis added by court).

The bankruptcy court adopted the rationale of *In re Virtual Network Services Corp.*, 902 F.2d 1246 (7th Cir. 1990), *Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990), and *Burden v. United States*, 917 F.2d 115 (3d Cir. 1990), that no creditor misconduct was required to subordinate the nonpecuniary loss tax penalty claims of the IRS pursuant to 11 U.S.C. § 510(c)(1), then weighed the various equities of the

claims (Pet. App. 44a-48a). Although finding that "[p]enalties may punish a debtor who is attempting to reorganize and may insure that the debtor obeys the tax laws," the court recognized that "in a Chapter 7 liquidation or in a liquidating chapter 11, the parties who are punished are other creditors because payment of penalties reduces estate assets available for distribution" and rejected the IRS's assertion that "requiring debtors to pay penalties which are administrative expenses does not punish innocent creditors, but rather insures that chapter 11 debtors obey the law while they are under the protection of the bankruptcy court" (Pet. App. 48a-49a).

> Weighing the foregoing against the Code's preference for compensating actual loss claims, and the fact that, in this liquidation proceeding, it appears the total amount of assets to be distributed will fully compensate only the first priority claim holders and will be distributed on a *pro rata* basis to the second priority claim holders, the court concludes that the equities tilt in favor of subordinating the postpetition non-pecuniary loss tax penalties sought by the IRS.

(Citations omitted) (Pet. App. 49a- 50a).

3. The district court affirmed (Pet. App. 26a-33a), first concluding that the equitable subordination provisions of 11 U.S.C. § 510 apply to administrative claims pursuant to the plain language of 11 U.S.C. § 726(a) (Pet. App. 30a), then concluding that the bankruptcy court properly balanced the equities:

> . . . . The IRS's claim for tax penalties is unquestionably a penalty, an additional

assessment, so to speak, for the debtor's having failed to pay the taxes and the interest due on the taxes in a timely manner, sums which, unlike the statutory penalties, represent actual losses (or the loss of the use of money) to the IRS. The IRS has priority to its claims for unpaid taxes and for interest on those taxes; therefore, it will not suffer a pecuniary loss if it does not obtain priority for the tax penalties. The same cannot be said for other creditors; rather, those persons provided value to FTL and will not receive that for which they bargained if the IRS is to be given priority for sums which do not represent out of pocket losses to it. Accordingly, this Court concludes that the equities tip in favor of subordinating the IRS's claim for tax penalties in this case.

(Footnote omitted) (Pet. App. 32a-33a).

4. The court of appeals, Judge Batchelder concurring, affirmed (Pet. App. 1a-22a). In seeking to reverse the lower court's decision, the IRS relied on the court of appeals' prior decision in *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055 (6th Cir. 1991), *cert. denied*, 502 U.S. 1092 (1992), as well as on three pre-1978 decisions of this Court which analyzed equitable subordination of certain pecuniary loss claims in light of alleged misconduct by the dominant shareholder (Pet. App. 5a, citing *Comstock v. Group of Institutional Investors*, 335 U.S. 211 (1948); *Pepper v. Litton*, 308 U.S. 295 (1939); and *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307 (1939)). The court of appeals observed:

> . . . . The view of the Commissioner, while partially correct, constitutes an incomplete

> understanding of *Mansfield Tire*. This Court also said in *Mansfield Tire* that, while a bankruptcy court may not impose its own view of equity where Congress has set priorities, Section 510(c) expressly permits a bankruptcy court to apply the "principles of equitable subordination" to subordinate a claim "otherwise susceptible to subordination, such as a penalty."

(Pet. App. 5a). The appellate court also noted that the *Mansfield Tire* case did not address whether a tax penalty claim was susceptible to subordination, and that the Supreme Court cases cited by the IRS did not address the precise question before the court of appeals (Pet. App. 6a).

The court of appeals followed the analysis of the bankruptcy court and agreed that the legislative history of 11 U.S.C. § 510(c) indicates that a nonpecuniary loss tax penalty is properly subject to equitable subordination. First, at the time of enactment of the Bankruptcy Code on November 6, 1978, the case law on the principles of equitable subordination included *Comstock*, *supra*, *Pepper*, *supra*, and *Taylor*, *supra*, as well as one appellate case, *In re Stirling Homex Corp.*, 579 F.2d 206 (2d Cir. 1978), *cert. denied*, 439 U.S. 1074 (1979) (subordinating the claims of defrauded shareholders, even though they were not guilty of misconduct) (Pet. App. 12a). Second, citing section 57(j) of the former Bankruptcy Act, 11 U.S.C. § 93(j) (repealed), the absence of case law equitably subordinating tax penalty claims prior to the enactment of the Bankruptcy Code was because nonpecuniary loss tax penalty claims were not allowed by law (Pet. App. 12a). Third, the Supreme Court had interpreted § 93(j) broadly to disallow both secured and unsecured claims for tax penalties against the estate of the bankrupt (Pet. App. 12a-13a, citing *Simonson v. Granquist*, 369 U.S. 38 (1962)). Finally, the

court of appeals noted that three other federal appellate courts had held that claims for prepetition nonpecuniary loss tax penalties may be equitably subordinated in the appropriate case even though no governmental misconduct occurred, and that the reasoning of those cases was equally applicable to postpetition nonpecuniary loss tax penalty claims (Pet. App. 13a-14a, citing *Burden v. United States*, 917 F.2d 115 (3d Cir. 1990); *In re Virtual Network Services Corp.*, 902 F.2d 1246 (7th Cir. 1990); and *Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990)).

The court of appeals next focused on the distinction between pecuniary loss, or compensatory, penalties, and nonpecuniary loss, or punitive, penalties. That distinction is evident not only in 11 U.S.C. § 726, but also appears in the legislative history to 11 U.S.C. §§ 502, 505, and 507. The court of appeals determined that in light of the legislative history and the distinction made between pecuniary and nonpecuniary loss tax penalties, Congress intended the punitive nonpecuniary loss tax penalties to be subject to equitable subordination pursuant to 11 U.S.C. § 510(c) (Pet. App. 14a-17a).

> The essence of bankruptcy is equity. While Congress has over the years re-codified traditional notions of equity, the current Code vests in the bankruptcy court significant discretion and equitable powers. However, the bankruptcy court's equitable subordination powers must be exercised within the confines of the Bankruptcy Code. *In re Granger Garage, Inc.*, 921 F.2d 74, 77 (6th Cir. 1990). An examination of the Code reveals that the bankruptcy courts have the power to subordinate any claim to any other claim under the principles of equitable

> subordination; Congress has left the development of those principles to the courts. The wisdom of such a course is obvious, given the many ways in which parties to a bankruptcy seek advantage in recouping losses. We do not see the fairness or the justice in permitting the Commissioner's claim for tax penalties, which are not being assessed because of pecuniary losses to the Internal Revenue Service, to enjoy an equal or higher priority with claims based on the extension of value to the debtor, whether secured or not. Further, assessing tax penalties against the estate of a debtor no longer in existence serves no punitive purpose. Because of the nature of postpetition, nonpecuniary loss tax penalty claims in a Chapter 7 case, we believe such claims are susceptible to subordination. To hold otherwise would be to allow creditors who have supported the business during its attempt to reorganize to be penalized once that effort has failed and there is not enough to go around.

(Pet. App. 18a-19a). Having determined that nonpecuniary loss tax penalty claims were subject to equitable subordination pursuant to 11 U.S.C. § 510(c), the court of appeals then considered whether the equities had been properly balanced in this case, and affirmed the decision of the district court (Pet. App. 20a).

Judge Batchelder concurred only to express her view that 11 U.S.C. § 726(a) was clear and unambiguous, and that there was no reason to speculate as to Congressional intent concerning that

section (Pet. App. 21a). Judge Batchelder agreed that it was proper to explore the legislative history behind 11 U.S.C. § 510(c) in order to determine Congressional intent concerning the undefined term "principles of equitable subordination," and concluded (Pet. App. 22a):

> Section 726(a) explicitly, clearly, and unambiguously makes the distribution of the property of the estate subject to the provisions of § 510(c). Postpetition non-pecuniary loss tax penalties are therefore subject to equitable subordination. End of story.

INTRODUCTION AND SUMMARY OF ARGUMENT

The court of appeals held that a postpetition punitive nonpecuniary loss tax penalty claim may on a case by case basis be subordinated pursuant to 11 U.S.C. § 510(c)(1) to the claims of parties who gave value to the debtor. This holding is consistent with the plain meaning of 11 U.S.C. § 510(c)(1), is consistent with longstanding bankruptcy policy that provides similar treatment to similar claims, and is consistent with providing superpriority pursuant to 11 U.S.C. § 364(c) over any or all administrative expense claims to parties who support a trustee or debtor in possession in the operation of a business during a chapter 11 case.

Tax penalties are intended to punish persons who have been guilty of some default or wrong; the enforcement of penalties against bankruptcy estates is disfavored because it would punish entirely innocent creditors rather than the delinquent taxpayers. *Simonson v. Granquist*, 369 U.S. 38, 40-41 (1962). Whereas compensatory pecuniary loss tax penalty claims are treated like

other pecuniary loss claims, including compensatory pecuniary loss tax claims, the Bankruptcy Code subordinates disfavored punitive nonpecuniary loss tax penalty claims. *See* 11 U.S.C. § 507(a)(7)(G);[1] 11 U.S.C. § 726(a)(4). It is also clear from the remainder of the statutory scheme that nonpecuniary loss tax penalty claims are disfavored and may be treated differently from pecuniary loss claims.

The lower courts have held that the postpetition nonpecuniary loss tax penalty claims in this case are administrative expenses under 11 U.S.C. § 503(b)(1)(C). The decisions of other courts which determine the *allowance* of postpetition claims as administrative expense claims but do not address whether those allowed claims can be subordinated, and the prior decisions of this Court permitting the subordination of the *pecuniary* loss claims of dominant shareholders who engaged in misconduct or breached their fiduciary duties to other creditors, are not controlling in this case whose only issue is the *subordination* of allowed postpetition punitive *nonpecuniary* loss tax penalty claims.

Nonpecuniary loss tax penalty claims, by their very nature, are susceptible to subordination pursuant to 11 U.S.C. § 510(c)(1) without a finding of misconduct on the part of the claimant. It is also evident from the legislative history that the development of the principles of equitable subordination is left to the courts. It would be improper to carve out a broad exception to 11 U.S.C. § 510(c) for tax penalties when the statute on its face

---

1. Prepetition taxes were given sixth priority when the Bankruptcy Code was enacted. 11 U.S.C. § 507(a)(6) (1982). Section 507(a) has been amended twice since then to include additional categories of priority claims payable before prepetition taxes. Prepetition taxes thus currently receive eighth priority. 11 U.S.C. § 507(a)(8). Because the priority for prepetition taxes was seventh at all times relevant to this case, we refer to it herein as "seventh" priority and cite to it as 11 U.S.C. § 507(a)(7).

permits the subordination for purposes of distribution of all or part of an allowed claim of any priority ranking to all or part of another allowed claim. The scales of justice should not be shackled, but should instead be permitted to move freely so that courts may balance the equities of competing claims on a case by case basis and determine whether subordination pursuant to 11 U.S.C. § 510(c) is proper.

Because 11 U.S.C. § 510(c)(1) permits the subordination of postpetition punitive nonpecuniary loss tax penalty claims and because the balance of the equities in this case favor general unsecured creditors who suffered actual losses, as opposed to the IRS, which retains priority for its compensatory tax and interest claims but suffered no actual loss on account of its nonpecuniary loss tax penalty claim, subordination of the postpetition nonpecuniary loss tax penalty claims of the IRS was proper in this case and the decision of the court of appeals should be affirmed.

ARGUMENT

EQUITABLE SUBORDINATION OF THE POSTPETITION NONPECUNIARY LOSS TAX PENALTY CLAIMS OF THE IRS PURSUANT TO 11 U.S.C. § 510(c) WAS PROPER.

After vigorously opposing the application of 11 U.S.C. § 510(c) to administrative expense nonpecuniary loss tax penalty claims (Pet. App. 4a-5a), the IRS has finally conceded that it is unable to evade the plain meaning of 11 U.S.C. § 726(a),[2]

2. Section 726(a) provides in pertinent part:

> (a) Except as provided in section 510 of this title, property of the estate shall be distributed —

(Cont'd)

which makes the principles of equitable subordination set forth in 11 U.S.C. § 510 applicable to its claims. Brief for the United States (hereinafter "Brief") at 10. The issue before this Court is whether bankruptcy courts will be permitted to weigh the equities of competing claims on a case by case basis, as expressly permitted by 11 U.S.C. § 510(c)(1), and in an appropriate case subordinate the postpetition punitive nonpecuniary loss tax penalty claims of the IRS to the pecuniary loss claims of parties who gave value to the debtor.

The task of determining the meaning of 11 U.S.C. § 510(c)(1) begins with the language of the statute itself. *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241 (1989). Section 510(c)(1) of the Bankruptcy Code provides:

> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may —
>
> (1) under principles of equitable

(Cont'd)

> (1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title, proof of which is timely filed under section 501 of this title or tardily filed before the date on which the trustee commences distribution under this section;
>
> • • •
>
> (4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim . . .

> subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest . . .

Although it is clear from the plain meaning of 11 U.S.C. § 726(a) that the principles of equitable subordination may be applied to any claim in a chapter 7 case, the term "principles of equitable subordination" is not defined in the Bankruptcy Code. Petitioner requests that this Court create an exception to exclude *all* tax penalties from the operation of 11 U.S.C. § 510(c)(1) unless there is inequitable conduct by the IRS. Such an exception is contrary to the statute and would undermine the flexibility necessary for the proper operation of the Bankruptcy Code.

A. Since Nonpecuniary Loss Claims Are Fundamentally Different from Pecuniary Loss Claims, They May Be Treated Differently.

The underlying theme of bankruptcy law is equality of distribution. This has been recognized both under the former Bankruptcy Act, *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941), and under the Bankruptcy Code. *Begier v. Internal Revenue Service*, 496 U.S. 53, 58 (1990). That theme, which recognizes that similar claims should receive similar treatment, is generally implemented through broad categories for classifying claims, exemplified by 11 U.S.C. § 507, and by providing for the orderly distribution to classes of claims, exemplified by 11 U.S.C. § 726. It is undisputed that both the classification of categories of claims in bankruptcy cases, as well as the order of distribution to those claimants, have been fixed by the statutory provisions enacted by Congress. Petitioner asserts, however, that the application of the principles of equitable

subordination on a case by case basis to subordinate punitive nonpecuniary loss tax penalties in an appropriate case improperly creates a new class of claims. Brief at 9-18.[3] The five

---

3. The IRS cites *In re Columbia Ribbon Co.*, 117 F.2d 999 (3d Cir. 1941) and *United States v. Killoren*, 119 F.2d 364 (8th Cir. 1941), *cert. denied*, 314 U.S. 640 (1941), for the proposition that bankruptcy courts cannot, by granting a priority which they deem equitable, set up a subclass having priority within a class. *Columbia Ribbon*, 117 F.2d at 1001; *Killoren*, 119 F.2d at 366. In both cases insufficient funds were available to pay administrative expense claims. Under section 64a of the former Bankruptcy Act, 11 U.S.C. § 104a (repealed), administrative expenses shared on a *pro rata* basis in the funds available for payment, regardless of whether the administrative expenses were incurred during the reorganization period or during the liquidation period.

In contrast to the facts of this case, all claimants in *Columbia Ribbon* and *Killoren* gave value to the estates and suffered pecuniary losses, and the courts were effectively asked to grant a superpriority to the administrative expenses incurred in the liquidation period over the administrative expenses incurred in the reorganization period. Notwithstanding its stated refusal to set up a subclass of claims, the *Columbia Ribbon* court nonetheless paved the way for the lower court to engage in the ultimate subordination of administrative expense claims by disallowing them:

> Since the Bankruptcy Act now permits creditors, stockholders and their counsel who assist in a reorganization effort to receive allowances even if a reorganization is not effected, the apparent injustice of permitting counsel for the stockholders and the creditors' committee to share pro rata with the trustees and their counsel and the trustees' creditors in a fund which is inadequate to pay them all in full is not ground for altering the scheme of priority fixed by the statute. We think, however, that in making such allowances in a proceeding where reorganization has failed, the court should fix the amount of the allowances in the light of the fund available for administration expenses and of other claims upon that fund. Where, as here, the fund is found inadequate, the court, *in the exercise of its discretionary power*, may well reconsider and reduce

(Cont'd)

federal courts of appeals which have considered whether nonpecuniary loss tax penalty claims may be subordinated pursuant to 11 U.S.C. § 510(c)(1) have rejected that proposition, and uniformly agree that subordination is not automatic and must be determined on a case by case basis.[4] Those courts have merely

---

(Cont'd)

> unpaid allowances previously made to parties in interest and their counsel (even remitting the latter altogether to their clients for their compensation) if it is deemed necessary to do so in order to provide more adequately for the payment of the allowances made to the court's own officers - the trustees - and their counsel and payment of the claims of the trustees' creditors.

(Emphasis added). *Columbia Ribbon*, 117 F.2d at 1002-03. In other words, the equities of the competing administrative expense pecuniary loss claims could be weighed, and because the reorganization was not successful, the harsh remedy of disallowance of the reorganization period claims could be imposed, thereby enhancing the distribution to the liquidation period administrative expense claimants having equal priority - a result which seems contrary to the court's reasoning, but which is consistent with the court's exercise of its discretionary power to subordinate for purposes of distribution all or part of and allowed claim to all or part of another allowed claim pursuant to 11 U.S.C. § 510(c).

4. *In re Virtual Network Services Corp.*, 902 F.2d 1246, 1250 (7th Cir. 1990) ("... we conclude that § 510(c)(1) authorizes courts to equitably subordinate claims to other claims on a case-by-case basis without requiring in every instance inequitable conduct on the part of the creditor claiming parity among other unsecured general creditors."); *Schultz Broadway Inn v. United States*, 912 F.2d 230, 234 (8th Cir. 1990) ("... we do observe that in an appropriate case circumstances may arise such that the bankruptcy court, after consideration of the relative equities, may determine that subordination should not apply to the Government's non-pecuniary loss claims vis-a-vis the actual loss claims of some or all creditors."); *Burden v. United States*, 917 F.2d 115, 119 (3d Cir. 1990) ("While we agree with the district court and the debtor that equitable subordination of nonpecuniary loss tax penalties is permissible,

(Cont'd)

applied 11 U.S.C. § 510(c)(1) according to its plain meaning to *permit*, under principles of equitable subordination, the subordination for purposes of distribution of all or part of an allowed claim to all or part of another allowed claim. The effect of the subordination is merely to adjust the equities among claimants and to regulate distribution.[5] A. Herzog and J. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 Vand. L. Rev. 83, 87 (1961).

It would be improper to shackle the scales of justice and carve out a broad exception to 11 U.S.C. § 510(c)(1) which would place all tax penalties beyond the reach of the equitable powers of the court unless there is inequitable conduct by the government. Section 510(c)(1) requires that each penalty be evaluated on its merits relative to other allowed claims. The payment of a nonpecuniary loss tax penalty may have a

---

(Cont'd)

we also believe that Congress did not intend such a radical alteration in the equitable subordination doctrine as to permit automatic subordination simply because the claim is for nonpecuniary loss tax penalties. Such a major revision in the bankruptcy law would certainly warrant explicit direction from Congress." The court of appeals then reversed and remanded to the district court because it erred as a matter of law by subordinating the nonpecuniary loss tax penalty claims of the IRS without considering the equities involved in the various claims."); *In re First Truck Lines, Inc.*, 48 F.3d 210, 218 (6th Cir. 1995), *cert. granted*, No. 95-323 (December 1, 1995) ("Our decision today does not mean that every tax penalty assessed by the Commissioner will be equitably subordinated.") (Pet. App. 20a); *In re CF & I Fabricators of Utah, Inc.*, 53 F.3d 1155, 1159 (10th Cir. 1995), *cert. granted*, No. 95-325 (December 1, 1995) (following *Virtual Network Services*, *supra*, and concluding that the bankruptcy court correctly addressed the equities in the case).

5. When a claim is subordinated, the funds which would have been distributed to that claimant are distributed instead to the non-subordinated claimants until they are paid to the extent allowed by the court. The application of the doctrine of equitable subordination is illustrated by the hypothetical printed in Appendix A, *infra*.

negligible impact in one case and a draconian effect in another. Factors to be considered include the nature of the penalty,[6] whether the penalty is to be paid from the estate of an individual, a partnership, or a corporation, the amount of the penalty relative to the amount of other allowed claims, and the nature of the bankruptcy relief sought by the debtor.[7] Neither the Bankruptcy

6. The distinction between compensatory pecuniary loss penalties and punitive nonpecuniary loss penalties has been recognized by Congress under the former Bankruptcy Act, *see* section 57(j), 11 U.S.C. § 93(j) (repealed), as well as under the Bankruptcy Code, *see* 11 U.S.C. § 507(a)(7)(G), 11 U.S.C. § 726(a)(4). The unfairness of allowing payment to the IRS on account of its punitive tax penalties when other creditors have not been paid for their pecuniary losses has been considered by the courts of appeals in determining that governmental misconduct was not required in order to permit the subordination of nonpecuniary loss tax penalty claims. *See Virtual Network Services*, 902 F.2d at 1250; *Schultz Broadway Inn*, 912 F.2d at 234; *First Truck Lines*, 48 F.3d at 218-19 (Pet. App. 20a); *CF & I*, 53 F.3d at 1159.

7. Thus, because the consequences would be very similar to a proceeding under chapter 7, the Eighth Circuit Court of Appeals subordinated a nonpecuniary loss tax penalty against a corporate debtor in a liquidating chapter 11 case in order to protect ordinary creditors from the debtor's punitive obligations. However, that court also recognized that a different result might be appropriate if a debtor reorganized under chapter 11 and ultimately returned to a viable and profitable economic state. *Schultz Broadway Inn*, 912 F.2d at 233.

In the present case, FTL did not ultimately return to a viable and profitable economic state, and the consequences in this converted case are very similar to those in a proceeding commenced under chapter 7. A reorganized debtor is in many respects similar to a prepetition debtor because the confirmation of a chapter 11 plan generally vests all of the property of the estate in the debtor. 11 U.S.C. § 1141(b). Because the property of the estate had revested in FTL, the conversion of FTL's case to chapter 7 was tantamount to the filing of a new petition. Therefore, although the penalties at issue arose postpetition, to the extent that those penalties also arose after confirmation of FTL's chapter 11 plan due to the failure of FTL to pay postconfirmation taxes,

(Cont'd)

Code, the common law, nor the legislative history to 11 U.S.C. § 510(c) include a misconduct requirement as a prerequisite to the subordination of punitive nonpecuniary loss tax penalties in an appropriate case. The decision of the court of appeals should therefore be affirmed.

B. Other Provisions of the Bankruptcy Code Support the Subordination of Punitive Nonpecuniary Loss Tax Penalty Claims.

1. Section 57(j) of the former Bankruptcy Act, 11 U.S.C. § 93(j)(repealed),[8] "plainly manifest[ed] a congressional purpose to bar all claims of any kind against a bankrupt except those based on a 'pecuniary' loss. . . . [T]he prohibition of all tax penalties in bankruptcy is wholly consistent with the policy of the penalty provisions themselves. Tax penalties are imposed at least in part as punitive measures against persons who have been guilty of some default or wrong. Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors" (Footnote omitted). *Simonson v. Granquist*, 369 U.S. 38, 40-41 (1962). When the Bankruptcy Code was enacted, it made significant changes in both the substantive and procedural law of bankruptcy. *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 53 (1982). One of

(Cont'd)

see Appendix B, *infra* at 9a, the Congressional intent to subordinate prepetition nonpecuniary loss tax penalties in chapter 7 cases, *see* 11 U.S.C. § 726(a)(4), should be equally applicable here.

8. Section 57(j) provides in pertinent part that "[d]ebts owing to the United States or any State or subdivision thereof as a penalty or forfeiture shall not be allowed, *except for the amount of the pecuniary loss sustained by the act, transactions, or proceeding out of which the penalty or forfeiture arose* . . ." (Emphasis added).

those many changes is the statutory allowance of nonpecuniary loss tax penalty claims in bankruptcy cases;[9] another is the codification of the doctrine of equitable subordination in 11 U.S.C. § 510(c).

Because the Bankruptcy Code substantially overhauled the bankruptcy system, "it is not appropriate or realistic to expect Congress to have explained with particularity each step it took, rather, as long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute." *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 240-41 (1989). The statutory scheme of the Bankruptcy Code is coherent and consistent and supports subordination of nonpecuniary loss tax penalty claims.

The punitive nonpecuniary loss tax penalty claims at issue in this case are administrative expenses pursuant to 11 U.S.C. § 503(b)(Pet. App. 3a). Pursuant to 11 U.S.C. § 726(a)[*see* note 2, *supra*], the provisions of 11 U.S.C. § 510 apply to administrative expenses allowed pursuant to 11 U.S.C. § 503(b). The appellate court applied section 510(c)(1) as expressly permitted by section 726(a) to weigh the equities of the nonpecuniary loss tax penalty claims of the IRS against other allowed claims. An examination of the remainder of the Bankruptcy Code establishes that no misconduct is required prior to the application of the principles of equitable subordination to the nonpecuniary loss tax penalty claims of the IRS in this case.

> Statutory construction ... is a holistic endeavor. A provision that may seem

9. The allowance of claims generally is controlled by 11 U.S.C. § 502. The allowance of administrative expense penalty claims is controlled by 11 U.S.C. § 503(b)(1)(C) [*see* note 10, *infra*].

> ambiguous in isolation is often clarified by the remainder of the statutory scheme — because the same terminology is used elsewhere in a context that makes its meaning clear ... or because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law.

(Citations omitted). *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 371 (1988).

Although the Bankruptcy Code fails to expressly distinguish between postpetition pecuniary loss and postpetition nonpecuniary loss tax penalty claims, 11 U.S.C. § 503(b)(1)(C),[10] the Bankruptcy Code elsewhere repeatedly

10. Sections 503(b)(1)(B) and (C) provide in pertinent part:

> (b) After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including —
>
> • • •
>
> (B) any tax —
>
> (i) incurred by the estate, except a tax of a kind specified in section 507(a)(7) of this title ...
>
> • • •
>
> (C) any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph.

distinguishes between pecuniary loss tax penalty claims and nonpecuniary loss tax penalty claims, and invariably subordinates the punitive nonpecuniary loss tax penalties to the compensatory pecuniary loss tax penalties. *See* 11 U.S.C. § 507(a)(7)(G);[11] 11 U.S.C. § 726(a)(4).[12] This is consistent with the bankruptcy policy of favoring pecuniary loss claims over nonpecuniary loss claims. *See Simonson v. Granquist*, 369 U.S. at 40-42 (1962).

By consistently ignoring the plain language of the statutory sections of the Bankruptcy Code which it cites, the IRS seeks to cloak its nonpecuniary loss tax penalties, which have

11. Section 507(a)(7) provides in pertinent part:

> (a) The following expenses and claims have priority in the following order:
>
> • • •
>
> (7) Seventh, allowed unsecured claims of governmental units, only to the extent that such claims are for —
>
> • • •
>
> (G) a penalty related to a claim of a kind specified in this paragraph *and in compensation for actual pecuniary loss*. (Emphasis added).

12. Moreover, the Bankruptcy Code envisions that claims that are substantially similar to one another be classified together and receive the same treatment. *See* 11 U.S.C. § 1122(a); 11 U.S.C. § 1222(a)(3); 11 U.S.C. § 1322(a)(3). It follows that claims such as punitive nonpecuniary loss tax penalty claims, which are not substantially similar to compensatory pecuniary loss tax penalty claims, may receive different treatment that that accorded to compensatory pecuniary loss tax penalty claims.

traditionally been disfavored, *see Simonson*, *supra*, with the preferred status of compensatory pecuniary loss penalties. Petitioner is wrong when it states that "[s]ection 726(a)(4) expressly subordinates prepetition tax penalties to general unsecured claims." Brief at 19 n.6; *see also* Brief at 22-23 ("Section 726 provides first priority for claims for *post*petition tax penalties but subordinates claims for *pre*petition penalties to general unsecured claims.") To the contrary, 11 U.S.C. § 726(a)(4) only subordinates penalties "to the extent that such . . . penalt[ies] . . . are not compensation for actual pecuniary loss suffered by the holder of such claim." Compensatory penalties are not subordinated; they receive the same status as other general unsecured claims in chapter 7 cases. Petitioner is also wrong when it states that "[i]n cases outside of Chapter 7, prepetition tax penalties are paid on a parity with general unsecured claims." Brief at 20 n. 6. Pursuant to 11 U.S.C. § 507(a)(7)(G), a penalty which is "in compensation for actual pecuniary loss" and related to an allowed unsecured priority claim of a governmental unit is itself entitled to priority over general unsecured claims, rather than treated on a parity with general unsecured claims.[13] It is only the nonpecuniary loss penalty claims which are paid on a parity with general unsecured claims outside of Chapter 7.[14]

13. Section 507(a)(7)(G) of the Bankruptcy Code applies not only to Chapter 11, 12 and 13, it also applies to Chapter 7 cases. 11 U.S.C. § 103(a); *see also* 11 U.S.C. § 726(a)(1). By its terms, 11 U.S.C. § 726(a)(4) applies to nonpecuniary loss penalty claims in a chapter 7 case arising before the earlier of the order for relief or the appointment of a trustee.

14. The payment of nonpecuniary loss penalty claims on a parity with general unsecured claims in chapter 11 cases creates a potential problem due to the requirement that a chapter 11 plan meet the best interest of creditors test in order to be confirmed. The best interest of creditors test, codified in 11 U.S.C. § 1129(a)(7), is an integral part of the confirmation requirements for chapter 11 plans. The test requires that creditors receive no less in a chapter 11 distribution than they would receive if the debtor were liquidated in a case under chapter 7 as of the effective date of the plan.

(Cont'd)

2. In addition to the statutory allowance of postpetition taxes and penalties as administrative expenses, 11 U.S.C. § 503(b)(1)(B), (C) [*see* note 10, *supra*], Congress has also given bankruptcy courts very broad powers to allow claims as administrative expenses when a trustee or debtor in possession[15] operates the business of the debtor. 11 U.S.C. § 364.[16] Congress

(Cont'd)

If prepetition nonpecuniary loss tax penalty claims were automatically subordinated in a chapter 7 case but were precluded from being subordinated in a chapter 11 case because the claimant had not engaged in inequitable conduct, the debtor's chapter 11 plan could not be confirmed and the bankruptcy policy of promoting reorganization would be thwarted. Even if a liquidating chapter 11 plan were proposed, it could not be confirmed if misconduct were a prerequisite to equitable subordination of the nonpecuniary loss tax penalty claims. It would be absurd to require conversion to chapter 7, with its attendant administrative expenses, in order to obtain the statutory right to subordinate the nonpecuniary loss tax penalties in a liquidation when the same result could be achieved by applying the principles of equitable subordination contained in 11 U.S.C. § 510(c). *In re Cassis Bistro, Inc.*, 188 Bankr. 472, 475 (Bankr. S.D.Fl. 1995). The operation of the best interest of creditors test is illustrated by the hypothetical printed in Appendix C.

15. Pursuant to 11 U.S.C. § 1101(1), "debtor in possession" means debtor in a chapter 11 case unless a person that has qualified under 11 U.S.C. § 322 is serving as trustee in the case. A debtor in possession generally has the same rights and powers as a trustee serving in a chapter 11 case, including the right and power to operate a debtor's business. 11 U.S.C. §§ 1107, 1108.

16. Section 364 of the Bankruptcy Code provides in pertinent part:

> (a) If the trustee is authorized to operate the business of the debtor under section 721, 1108, 1203, 1204, or 1304 of this title, unless the court orders otherwise, the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.

(Cont'd)

recognized the paramount importance[17] of extending credit to

(Cont'd)

> (b) The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.
>
> (c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt —
>
> (1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;
>
> (2) secured by a lien on property of the estate that is not otherwise subject to a lien; or
>
> (3) secured by a junior lien on property of the estate that is subject to a lien.
>
> • • •
>
> (e) The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.

17. The high priority placed on postpetition financing is evident in light of the extraordinary protections given to any party which extended credit from an adverse ruling on appeal of the order authorizing the trustee or debtor in possession to obtain credit. *See* 11 U.S.C. § 364(e), note 16, *supra*.

help a trustee or debtor in possession operate a business and expressly gave the bankruptcy courts authority to elevate these claims of creditors who give value to a superpriority status over allowed administrative expense claims. 11 U.S.C. § 364(c). The subordination of postpetition nonpecuniary loss tax penalty claims is entirely consistent with this statutory scheme which elevates the postpetition claims of parties, which give value so that the business of a debtor can operate, over other administrative expense claims.

Subordination of postpetition nonpecuniary loss tax penalty claims should also be favored as a practical matter. If postpetition nonpecuniary loss tax penalty claims are not subject to being subordinated without a finding of inequitable conduct by the claimant, any party doing business or extending credit postpetition to a trustee or debtor in possession will insist on superpriority status before providing goods or services. The bankruptcy estate and the provider of goods or services will incur increased expenses in order to protect the provider of goods or services. Delays will arise due to the need to work out the terms of the agreement and to obtain court approval of the superpriority status. These delays could be fatal to a business dependent on the delivery of the goods or services for its continued operation. If subordination of nonpecuniary loss tax penalties is not available, the attendant increase in costs and delays will both be contrary to the strong bankruptcy policy in favor of rehabilitating or reorganizing debtors.

Although 11 U.S.C. § 364 could be used in future cases to achieve the result achieved below in this case, it should not be necessary to engage in that tortuous and expensive process because application of the principles of equitable subordination permits the subordination of postpetition punitive nonpecuniary loss tax penalty claims in appropriate cases.

The distinction between pecuniary and nonpecuniary loss

claims, the preferred status of parties who provide value to permit a trustee or debtor in possession to operate postpetition, and the disfavored status of punitive nonpecuniary loss penalties inexorably lead to the conclusion that, in a chapter 7 case where the corporate debtor has ceased to operate, entirely innocent claimants who suffered actual pecuniary losses should not bear the additional burden of the nonpecuniary loss tax penalty claims of the IRS which arose from the failure of the debtor to pay certain taxes arising from its operation after the debtor filed its chapter 11 petition but before its case was converted to chapter 7. By codifying the doctrine of equitable subordination at the same time as allowing penalty claims, Congress provided a necessary counterbalance in appropriate cases such as this to assure that the remedial subordination provisions of 11 U.S.C. § 510(c)(1) are available to protect entirely innocent claimants who gave value from the detrimental impact of misguided nonpecuniary loss tax penalty claims.

C. Subordination of Punitive Nonpecuniary Loss Tax Penalty Claims Is Consistent with Prior Decisions of This Court.

1. This Court has never decided whether nonpecuniary loss tax penalty claims can be equitably subordinated. Neither *Boteler v. Ingels*, 308 U.S. 57 (1939) nor *Nicholas v. United States*, 384 U.S. 678 (1966) address that issue. Both *Boteler* and *Nicholas* found that postpetition penalties incurred by the bankruptcy trustee could be allowed as administrative expense claims. Equitable subordination was not at issue.

In *Boteler*, the Court sustained a penalty against a trustee in bankruptcy who failed to pay state license fees while operating the business of the bankrupt estate for purposes of liquidation. 308 U.S. at 61. In *Nicholas*, the trustee failed to timely file returns for the taxes incurred by a debtor in possession during the Chapter XI arrangement proceeding. 384 U.S. at 695. The Court found that "[n]o legitimate interest would be served by

permitting the trustee to escape the unburdensome responsibility of merely filing the returns and thereby notifying the United States of the taxes that are due." *Id.* Furthermore, the payment of penalties due to the trustee's failure to file tax returns did not involve any major inequities between creditors of the same class. 384 U.S. at 693 n. 27. Neither *Boteler* nor *Nicholas* concerned the subordination of claims. Instead, they merely stand for the proposition that postpetition penalty claims are allowed claims within the category of claims known as administrative expense claims.[18]

2. The decisions of this Court which do address the application of the doctrine of equitable subordination of allowed claims involve pecuniary loss claims of a dominant entity in a position of control which can improve its position to the detriment of other claimants in the case.

As initially formulated, the doctrine of equitable subordination was virtually unlimited. "The power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete." *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941) (Citing *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307 (1939) and *Pepper v. Litton*, 308 U.S. 295 (1939)).

18. Other cases which involve the allowance of administrative claims, rather than the subordination of allowed claims, are similarly distinguishable. *See New Jersey v. Anderson*, 203 U.S. 483, 494 (1906) (alleged tax was a true tax entitled to priority in payment pursuant to section 64a of the former Bankruptcy Act (repealed)); *In re Samuel Chapman, Inc.*, 394 F.2d 340, 341 (2d Cir. 1968), *cert. denied*, 393 U.S. 923 (1968); *United States Department of Interior v. Elliott*, 761 F.2d 168, 170 (4th Cir. 1985). The allowance of postpetition tax or penalty claims as determined by these cases has been codified in 11 U.S.C. § 503(b)(1) [*see* note 10, *supra*]. These cases do not reach the subordination issue. Whether allowed postpetition nonpecuniary loss tax penalty claims may be subordinated pursuant to 11 U.S.C. § 510(c)(1) is the issue before this Court.

In *Taylor*, practically all of the common stock of the debtor, Deep Rock Oil Corporation, was owned by Standard Gas & Electric Co., which was claiming as a creditor. 306 U.S. at 309. Standard exercised complete control and domination over Deep Rock, often to the detriment of Deep Rock. 306 U.S. at 320, 323. The Court found that Deep Rock was bankrupt not only because it owed Standard enormous sums but because Standard abused its role in management due to the paramount interest of the interlocking officers and directors to preserve Standard's position as both proprietor and creditor of Deep Rock. 306 U.S. at 323. Under these circumstances, the Court applied broad equitable principles and declined to observe the doctrine of corporate entity because it would work fraud *or* injustice on the preferred shareholders. 306 U.S. at 322. Standard's claim was therefore subordinated to that of the injured preferred shareholders. 306 U.S. at 324.

Approximately nine months later, the Court in *Pepper v. Litton*, 308 U.S. 295 (1939), observed that the subordination in *Taylor* "was based on the equities of the case - the history of spoliation, mismanagement, and faithless stewardship of the subsidiary by Standard to the detriment of the public investors." 308 U.S. at 308. In *Pepper*, the Court considered the disallowance or subordination of the salary claim of a dominant and controlling shareholder relative to the claims of other creditors. The Court noted that bankruptcy courts are essentially courts of equity, and that their equitable powers had often "been invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." 308 U.S. at 305. The Court recognized that the disallowance or subordination of claims may be necessitated by certain cardinal principles of equity jurisprudence. 308 U.S. at 306. "In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift

the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate." (Footnote omitted). 308 U.S. at 307-08. Although misconduct or fraud is evident in *Pepper*, the Court's sweeping statements that the bankruptcy court may exercise its equitable jurisdiction to prevent injustice or unfairness in the administration of a bankruptcy estate suggest that misconduct is not required if there is either injustice or unfairness as contemplated by the *Taylor* or *Pepper* decisions.

The third decision of this Court addressing equitable subordination, *Comstock v. Group of Institutional Investors*, 335 U.S. 211 (1948), also arose under the former Bankruptcy Act and applied the teachings of *Taylor* and *Pepper* to another dominant shareholder situation. Once again, a pecuniary loss claim was involved. Although there was domination of the subsidiary, Justice Jackson, speaking for the five Justice majority, delivered the opinion of the Court and stated that "[i]t is not mere existence of an opportunity to do wrong that brings the rule [equitable subordination] into play; it is the unconscionable use of the opportunity afforded by the domination to advantage itself at the injury of the subsidiary that deprives the wrongdoer of the fruits of his wrong." 335 U.S. at 229. Subordination was therefore denied. In criticizing the majority decision, the four dissenting Justices pointed out that "[t]he equities which form the Deep Rock doctrine relate not alone to matters of bad faith. They are also concerned with the essential fairness and propriety of transactions from an objective standpoint. *Pepper v. Litton*, [308 U.S. at] 306." *Comstock*, 335 U.S. at 237-38 (Murphy, J., dissenting).

Taylor, *Pepper*, and *Comstock*, each *supra*, share the common thread that subordination may be proper against dominant shareholders who have suffered pecuniary losses but

engage in misconduct or breach their fiduciary duties to other creditors. The application of the principles of equitable subordination to nonpecuniary loss tax penalty claims does not require any departure from that general rule because the nonpecuniary loss tax penalty claims are punitive rather than compensatory, and are thus by their very nature disfavored and susceptible to subordination.[19] Such a result is consistent with both the former and current bankruptcy laws, with prior decisions of this Court, and with the legislative history to 11 U.S.C. § 510.

D. The Legislative History Accompanying 11 U.S.C. § 510(c) Supports the Subordination of Punitive Nonpecuniary Loss Tax Penalty Claims.

The Bankruptcy Act of 1898, as amended (repealed), contained no provision concerning the equitable subordination of claims analogous to 11 U.S.C. § 510(c)(1). Many proposals were considered with respect to the subordination of claims before Congress settled on the text of 11 U.S.C. § 510. One proposal suggested the subordination of "any claim, whether secured or unsecured, to the extent it is for a fine, penalty, or forfeiture or for multiple, punitive, or exemplary damages." *Report of the Commission on the Bankruptcy Laws of the United States*, H.R. Doc. No. 137, 93d Cong., 1st Sess. Pt. II, at 115, § 4-406(a)(3) (1973). That proposed statute did not distinguish between pecuniary and nonpecuniary loss penalties, but did

---

19. Other subordination decisions that pre-date the enactment of the Bankruptcy Code which the IRS cites in support of its position that misconduct is a required prerequisite to subordination are similarly distinguishable on the basis that the dispute involved the subordination of pecuniary loss claims. *See, i.e., Benjamin v. Diamond*, 563 F.2d 692, 695 (5th Cir. 1977) (pecuniary loss claims based upon debentures); *Stebbins v. Crocker Citizens Nat'l Bank*, 516 F.2d 784, 786 (9th Cir. 1975) (pecuniary loss claims based on promissory notes).

clearly state that the equitable power of a bankruptcy court to subordinate claims was not limited.[20]

The legislative history which accompanies 11 U.S.C. § 510 provides in pertinent part:

> Section 510 (c)(1) of the House amendment represents a compromise

---

20. Proposed section 4-406, entitled Subordination of Claims, provided in pertinent part:

> (a) *Subordinated Classes of Claims*. The following claims are subordinated in payment to all other nonsubordinated but allowable claims:
>
> • • •
>
> (3) any claim, whether secured or unsecured, to the extent it is for a fine, penalty, or forfeiture or for multiple, punitive, or exemplary damages.
>
> • • •
>
> (c) *Equitable Power of Court to Subordinate Other Claims*. This section does not limit the equitable power of a bankruptcy court to subordinate claims or to enforce voluntary subordination agreements.

Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93d Cong., 1st Sess. Pt. II, at 115, § 4-406 (1973).

Given the express authorization in 11 U.S.C. § 510(c) to subordinate all or part of an allowed claim to all or part of another allowed claim, the failure to retain a provision expressly subordinating penalties does not mean that penalties may not be subordinated under section 510(c); to the contrary, it means only that the subordination is not automatic.

> between similar provisions in the House bill and Senate amendment. After notice and a hearing, the court may, under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest. As a matter of equity, it is reasonable that a court subordinate claims to claims and interests to interests. It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if holder of such claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination, such as a penalty or a claim for damages arising from the purchase or sale of a security of the debtor.

124 Cong. Rec. H11,089, H11,095 (Sept. 28, 1978) (statement of Rep. Edwards); 124 Cong. Rec. S17,406, S17,412 (Oct. 6, 1978) (statement of Sen. DeConcini).

This quotation from the sponsors[21] of the Bankruptcy Reform Act demonstrates that "Congress contemplated that section 510(c)(1) would be used to subordinate claims involving *either* inequitable conduct *or* claims such as penalties that were

---

21. In the absence of a conference and in light of the key roles playes by the Senate and House floor managers, Senator DeConcini and Representative Edwards, their floor statements on the Bankruptcy Code may be treated as persuasive evidence of Congressional intent. *Begier v. Internal Revenue Service*, 496 U.S. 53, 64 n.5 (1990).

of a 'status susceptible to subordination.' " *Schultz Broadway Inn v. United States*, 912 F.2d 230, 233 (8th Cir. 1990). The preceding legislative history contains the following key elements:

> 1. The "principles of equitable subordination" are to follow then-existing case law.
>
> 2. Claims were generally subordinated if:
>
> a. the holder of the claim was guilty of inequitable conduct;
>
> b. the claim itself was of a status susceptible to subordination, such as a penalty, regardless of the claimant's conduct; or
>
> c. the claim itself was of a status susceptible to subordination, such as a claim for damages arising from the purchase or sale of a security of the debtor, regardless of the claimant's conduct.
>
> 3. Development of the principles of equitable subordination was left to the courts.

Since the IRS asserts that as of 1978, no court had held that a tax penalty or any other kind of penalty claims were subject to equitable subordination, Brief at 21, it is not surprising that the IRS repeatedly turns to additional legislative history in a futile attempt to prove that its nonpecuniary loss tax penalties are not

subject to equitable subordination. Brief at 17 n. 4, 22. The unabridged provisions from which the IRS quotes state:

> Subsection (b)[now moved to subsection c] authorizes the bankruptcy court, in ordering distribution of assets, to subordinate all or any part of any claim to all or any part of another claim, *regardless of the priority ranking of either claim*. In addition, any lien securing such a subordinated claim may be transferred to the estate. The bill provides, however, that any subordination ordered under this provision must be based on principles of equitable subordination. These principles are defined by case law, and have generally indicated that a claim may normally be subordinated only if its holder is guilty of misconduct. As originally introduced, the bill provided specifically that a tax claim may not be subordinated on equitable grounds. The bill deletes this express exception, but the effect under the amendment should be much the same in most situations since, under the judicial doctrine of equitable subordination, a tax claim would rarely be subordinated.

(Emphasis added). S. Rep. No. 95-989, 95th Cong., 2d Sess. 74 (1978). The IRS also relies on legislative history which provides:

> Since the House amendment authorizes subordination of claims only under principles of equitable subordination, and thus incorporates principles of existing case

law, a tax claim would rarely be subordinated under this provision of the bill.

124 Cong. Rec. H11,113 (Sept. 28, 1978); 124 Cong. Rec. S17,430 (Oct. 6, 1978).

Neither passage rescues the IRS. Not only was the exclusion of tax claims from the operation of the equitable subordination statute eliminated, the priority ranking of any claim did not affect whether it could be subordinated to any other claim. If Congress deemed it appropriate to make compensatory tax claims subject to the equitable subordination provisions of 11 U.S.C. § 510(c)(1), regardless of their priority rankings, the subordination provisions of the statute easily encompass disfavored nonpecuniary loss tax penalties.

The statement in the legislative history that "a tax claim would rarely be subordinated" also fails to aid the IRS. Tax claims are compensatory; nonpecuniary loss tax penalty claims are punitive. It is indisputable that the penalty provisions in the tax code are expressly meant to deter and punish, "two goals in contravention of any equity or equitable considerations." *In re Virtual Network Services Corp.*, 902 F.2d 1246, 1249 (7th Cir. 1990). This Court has long recognized that "[t]ax penalties are imposed at least in part as punitive measures against persons who have been guilty of some default or wrong. Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors." (Footnote omitted) *Simonson v. Granquist*, 369 U.S. 38, 40-41 (1962). The dissenting Justices in *Simonson* also agreed with that proposition. "I also agree that § 57j, 11 USC § 93(j), denying claims for penalties against the estate, reflects a policy against disadvantaging innocent creditors for the wrongs of the bankrupt." 369 U.S. at 42 (Frankfurter, J., dissenting).

The Congressional intent is clear. The subordination for purposes of distribution of all or part of an allowed claim to all or part of another allowed claim, regardless of the priority ranking of either claim, is expressly permitted by 11 U.S.C. § 510(c)(1). Punitive nonpecuniary loss tax penalties are of a disfavored status susceptible to subordination. Compensatory tax penalties are not of a disfavored status, and will rarely be subordinated. The development of the principles of equitable subordination has been left to the courts, and this Court should interpret 11 U.S.C. § 510(c)(1) to conform with bankruptcy policy and to carry out Congressional intent. Because the lower courts properly balanced the equities of the postpetition punitive nonpecuniary loss tax penalty claims of the IRS against the claims of creditors who gave actual value, subordination of the postpetition punitive nonpecuniary loss tax penalty claims of the IRS was proper in this case, and the Court should affirm the decision of the court of appeals.

has been left to the courts and this Court should interpret 11 U.S.C. § 510(c)(1) to conform with bankruptcy policy and to carry out congressional intent. Because the lower courts properly balanced the equities of the postpetition punitive nonpecuniary loss tax penalty claims of the IRS against the claims of creditors who gave actual value, subordination of the postpetition punitive nonpecuniary loss tax penalty claims of the IRS was proper in this case, and the Court should affirm the decision of the court of appeals.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

RAYMOND J. PIKNA, JR.
Counsel of Record
THOMAS R. NOLAND
ROBERT B. BERNER
GREGORY P. GARNER
ALTICK & CORWIN CO., L.P.A.
Attorneys for Respondent
1700 One Dayton Centre
One South Main Street
Dayton, Ohio 45402
(513) 223-1201

APPENDIX A — HYPOTHETICAL CHAPTER 11 DISTRIBUTION ANALYSIS

Assumptions:

1. All claims are administrative expense claims.

2. The sum of $315,000 is available to pay administrative expense claims which total $360,000.

3. The following administrative expense claims are allowed:

A. IRS pecuniary loss claim for taxes	$90,000
IRS pecuniary loss claim for interest	$45,000
IRS *nonpecuniary* loss claim for penalty	$45,000
Total IRS claims	$180,000
B. Trade (*i.e.* supplies, utilities, etc.)	
Principal amount of pecuniary loss claim	$90,000
Accrued interest pecuniary loss claim	$45,000
Total trade claims	$135,000
C. Professional fees (*i.e.* attorneys, accountants, etc.)	
Principal amount of pecuniary loss claim	$45,000
Total claims for professional fees	$45,000

Appendix A

Summary of claims:

Pecuniary loss claims

IRS - tax	$ 90,000
IRS - interest	$ 45,000
Trade - principal	$ 90,000
Trade - interest	$ 45,000
Professional - principal	$ 45,000
Total pecuniary loss claims	$315,000

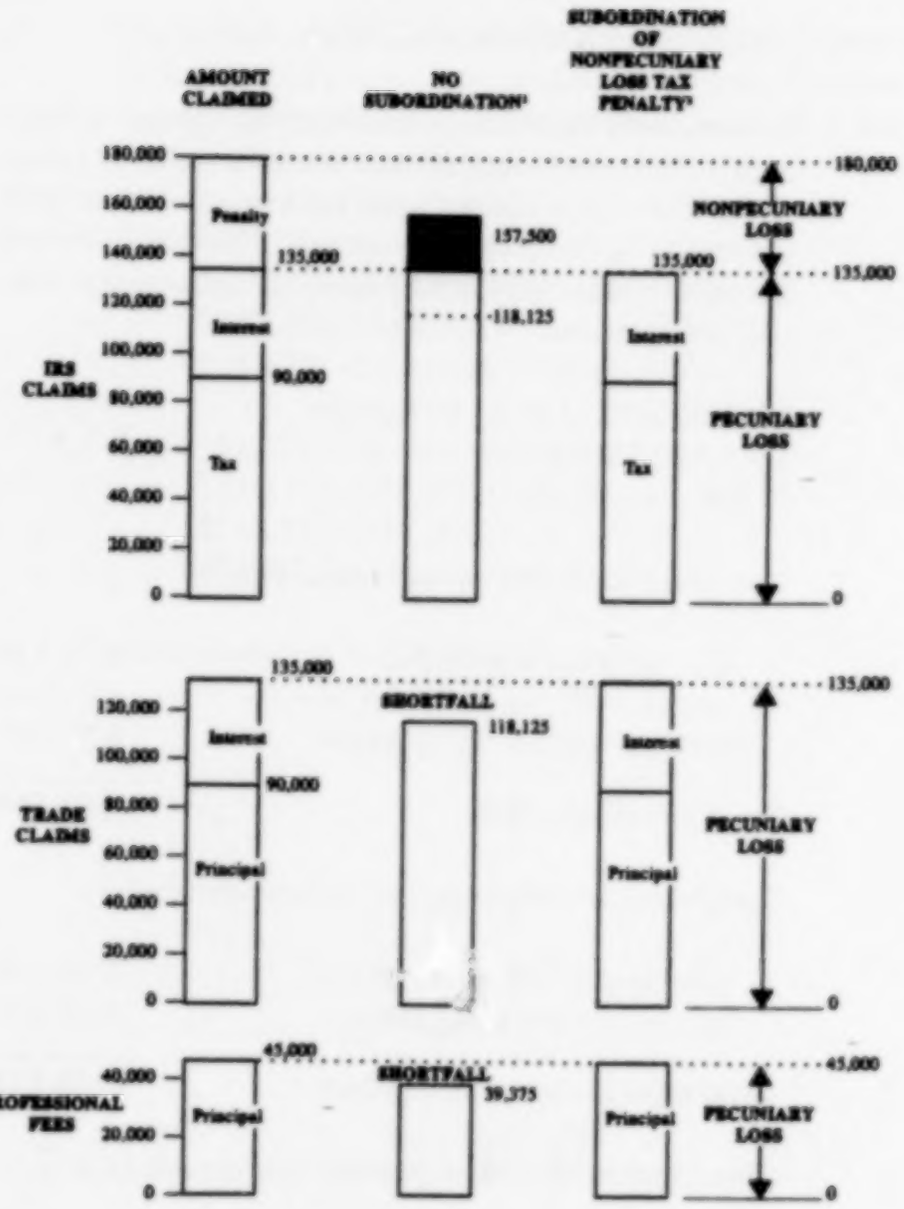
Nonpecuniary loss claims

IRS - penalty	$ 45,000
Total nonpecuniary loss claims	$ 45,000

Total claims

Pecuniary loss	$315,000
Nonpecuniary loss	$ 45,000
Total claims	$360,000

Appendix A



Appendix A

1. NO EQUITABLE SUBORDINATION

If there is no equitable subordination, the percentage distributed on account of each administrative expense claim is computed based upon the amount of available funds ($315,000) divided by the total amount of allowed pecuniary loss ($315,000) *and* nonpecuniary loss ($45,000) claims:

$315,000/($315,000 + $45,000) =
$315,000/$360,000 =
87.5%

Computation of amount payable to IRS:

tax: 87.5% x $90,000 =	$ 78,750
interest: 87.5% x $45,000 =	$ 39,375
penalty: 87.5% + $45,000 =	$ 39,375
Total payable to IRS	**$157,500**

Computation of amount payable to trade vendors:

principal 87.5% x $90,000 =	$ 78,750
interest 87.5% x $45,000 =	$ 39,375
Total payable to trade vendors	**$118,125**

Computation of amount payable to professionals:

principal 87.5% x $45,000 =	$ 39,375
Total payable to professionals	**$ 39,375**

Appendix A

The amount paid to a claimant as a percentage of the pecuniary loss claims is determined by dividing the total amount paid to that claimant by the total amount of that claimant's pecuniary loss claims.

IRS: $157,500/(tax + interest) =
$157,500/($90,000 + $45,000) =
$157,500/$135,000 =
116.67% of pecuniary loss claims

Trade: $118,125/(principal + interest) =
$118,125/($90,000 + $45,000) =
$118,125/$135,000 =
87.5% of pecuniary loss claims

Professional: $39,375/(principal) =
$39,375/($45,000) =
87.5% of pecuniary loss claims

Appendix A

2. SUBORDINATION OF NONPECUNIARY LOSS TAX PENALTY CLAIMS

If the nonpecuniary loss tax penalty claims are equitably subordinated, the percentage distributed on account of pecuniary loss claims is computed based upon the total amount of available funds divided by the amount of allowed pecuniary loss claims.

$315,000/(total pecuniary loss tax claims + total trade claims + total professional fees)
$315,000/[($90,000 + $45,000) + ($90,000 + $45,000) + $45,000] =
$315,000/$315,000 =
100%

The subordination of the nonpecuniary loss tax penalty claims of the IRS pursuant to 11 U.S.C. § 510(c)(1) permits all pecuniary loss claims, which by their nature are similar, to receive similar treatment.

APPENDIX B — REQUEST FOR PAYMENT OF INTERNAL REVENUE TAXES (PROOF OF CLAIM #102) WITH ATTACHED LETTER FILED NOVEMBER 22, 1988

REQUEST FOR PAYMENT OF INTERNAL REVENUE TAXES

(Bankruptcy Code Cases — Administrative Expenses)

Department of the Treasury/Internal Revenue Service

United States Bankruptcy Court for the Southern District of OH

In the Matter of:

FIRST TRUCK LINES, INC
1500 FARR DR
DAYTON OH 45404

Fiduciary:

Case Number
38600925

Type of Bankruptcy Case
Chap. 7

Date of Petition
04/10/86

Taxpayer Identifying Number
Social Security Number
Employer Identification Number
illegible

Appendix B

1. The undersigned, whose business address is *P.O. Box 1579, CINCINNATI, OH 45201,* is the agent of the Department of Treasury, Internal Revenue Service, and is authorized to make this request for payment on behalf of the United States.

2. Request is made for payment of taxes and any interest or penalty due under the internal revenue laws of the United States, as shown below.

3. The ground of liability is taxes due under the internal revenue laws of the United States.

Appendix B

Administrative Claims

Kind of Tax	*Tax Period*	*Tax Due*	*Accrued Interest as of 10 Days from the Date of this Request*	*Accrued Penalty as of 10 Days from the Date of this Request*	*Balance Due*
FUTA	12/31/87	3,055.66	478.62	175.18	3,709.46
FUTA	12/31/88	1,750.00	.00	.00	1,750.00
WT-FICA	09/30/87	16,423.86	3,029.20	8,586.02	28,039.08
WT-FICA	03/31/88	21,075.52	2,698.49	589.80	24,363.81
WT-FICA	06/30/88	24,862.92	4,848.18	7.40	29,718.50
CORP-INC	12/31/87	300.00	.00	.00	300.00

Appendix B

* ESTIMATED TAX CLAIMS HAVE BEEN FILED BECAUSE THE DEBTOR HAS FAILED TO FILE THE RETURN(S) FOR THE ESTIMATED PERIODS. AS SOON AS THE DEBTOR FILES THE RETURN(S) WITH THE I.R.S. AS REQUIRED BY LAW, THIS CLAIM WILL BE ADJUSTED AS NECESSARY.

Amount due as of 10 days from date of this request $87,880.85

Compound interest will accrue at the rate established under IRC Section 6621(b). Contact Chief, Special Procedures function at *see below* for balance due if paid after *11/28/88*. Dollar amount per month at which late payment penalty will be charged (at 1/2 of 1 percent a month) after 10 days from the date of this request $67,467.96

Penalty for Presenting Fraudulent Claim — Fine of not more than $5,000 or Imprisonment for not more than 5 years or both — Title 18, U.S.C., Section 152.

Signature
s/ Marilyn J. Hicks

Title
Manager, Procedures & Insolvency Unit

Date
11/18/88

Telephone Number
(513) 684-2442

Appendix B

INTERNAL REVENUE SERVICE
District Director

Department of the Treasury
P.O. Box 1579
ROOM 3511
CINCINNATI, OH 45201

Date: 11/18/88

Person to Contact:
T. ROBERTS

Contact Telephone Number:
(513) 684-2442

FIRST TRUCK LINES, INC

1500 FARR DR
DAYTON OH 45404

Refer Reply to:
C:S

Docket No. 38600925

We understand you are presently involved in a Chapter 7A Bankruptcy proceeding. Bankruptcy Code Section 507 gives priority claim status to unpaid taxes due the United States of America.

We have no record of receiving the Federal tax returns listed on page 2 of this letter. If you have filed, or if you are not required to file these returns, please provide the information requested.

If you are required to file, attach the returns to this letter and send them to us at the address shown above within 10 days from the date of this letter.

Appendix B

If we do not receive your response and/or delinquent returns within 10 days, we are compelled to proceed with appropriate legal action within the framework of both the Internal Revenue Code and the Bankruptcy Code.

Sincerely,

s/ Gary A. Blomberg
Gary A. Blomberg
Chief, Special Procedures Staff

cc: United States Bankruptcy Court BSDDA
Debtor's Attorney ------ PETER J. DONAHUE, ESQ.
P.O. BOX 1817

DAYTON, OH 45401-1817
Trustee ---------- THOMAS R. NOLAND
900 TALBOTT TOWER

DAYTON, OH 45402-1104

If you have filed the returns listed, please give us the name, address, Employer Identification Number or Social Security Number, date filed, and the amount paid with each. If you have a cancelled check that accompanied the return(s), please provide a copy of the front and back of the check.

If you are not required to file the return(s), please give us the reason and the date on which you were no longer liable.

Appendix B

Form #	Period Ended	Status
940	12/31/88 :	
1120	12/31/87 :	

Signature : _____

Title : _____

TEL # : _____

APPENDIX C — BEST INTEREST OF CREDITORS TEST HYPOTHETICAL [11 U.S.C. § 1129(a)(7)]

Assumptions:

1. Debtor seeks confirmation of its chapter 11 plan.

2. Debtor employs 500 people.

3. After payment of administrative expense and priority claims, $1,000,000 remains in the estate for distribution to unsecured creditors.

4. Pre-petition unsecured claims:

Nonpecuniary loss tax penalty claims [not entitled to priority : 11 U.S.C. § 507(a)(7)(G)]:	$ 450,000
Pecuniary loss general unsecured claims:	$ 800,000
Total unsecured claims	$1,250,000

5. Class of unsecured claims is impaired and does not accept the plan.

Distribution analysis under Chapter 11 plan if all unsecured claims are in the same class:

The percentage to be distributed to unsecured creditors is determined by dividing the tota! amount of funds available for distribution by the total amount of unsecured claims.

$1,000,000/$1,250,000 = 80%

Appendix C

Amounts to be distributed:

Nonpecuniary loss tax penalty claims: 80% x $450,000 = $360,000	
Pecuniary loss general unsecured claims: 80% x $800,000 = $640,000	
Total to be distributed	$1,000,000

Best interest of creditors analysis:

Pursuant to 11 U.S.C. § 1129(a)(7), if an impaired class of claims does not accept a plan, the plan cannot be confirmed unless that impaired class receives under the plan on account of such claim property of a value that is not less than the claimant would receive if the debtor were liquidated under chapter 7 of the Bankruptcy Code. Accordingly, the court in this example must determine how the $1,000,000 would be distributed pursuant to 11 U.S.C. § 726.

In this example, the administrative and priority claimants would be paid in full under the chapter 11 plan or in the chapter 7 case. The remaining $1,000,000 would then be paid pursuant to 11 U.S.C. § 726(a) as follows:

Available for distribution	$1,000,000
Amount paid to general unsecured pecuniary loss creditors pursuant to 11 U.S.C. § 726(a)(2)	$ 800,000
Amount to be paid to unsecured nonpecuniary loss tax penalty claimants pursuant to 11 U.S.C. § 726(a)(4) ($1,000,000 - $800,000)	$ 200,000

Appendix C

Since general unsecured pecuniary loss creditors would receive more ($800,000) in a chapter 7 case than would be distributed to them under the plan ($640,000), the plan would not be confirmed unless those creditors voted to accept the plan.

PROBLEM: How to meet the best interest of creditors test to obtain confirmation of the debtor's chapter 11 plan and save 500 jobs.

SOLUTION: Include in the chapter 11 plan a provision to subordinate the unsecured nonpecuniary loss tax penalty claims so that the general unsecured creditors would receive the same amount under the plan as would be paid to them if the funds were distributed in a chapter 7 case. No misconduct is required in order to subordinate the unsecured nonpecuniary loss tax penalty claims.